INSURANCE AND POLLUTION PREVENTION

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What is the relation between standard business insurance and pollution?

At the most general level, the cost of standard business insurance creates a potential incentive for pollution prevention. This potential incentive depends in part on an awareness by a firm that some portion of its insurance costs is the result of its use or generation of hazardous substances and other pollutants. This awareness, in turn, depends on an accounting system which identifies that portion of insurance costs resulting from environmental exposures.

A 1995 survey indicated that 55% of 1,000 large national firms do consider the effect of potential investments for environmental management on future insurance costs when evaluating these investments. However, the remaining firms surveyed and the great majority of smaller firms simply assign insurance to "administrative overhead." As a result, the cost of insurance is often unable to act as an incentive to implementation of pollution prevention.

Where both property and general commercial liability policies of a business absolutely exclude damages or liabilities resulting from pollution, does it follow that any possible insurance based incentives for pollution prevention are limited to firms with special environmental coverages?

No. Some portion of property insurance may reflect risks of fire and explosion resulting from use of substances which are both flammable and explosive, and, concurrently, classified as "hazardous." Consequently, a reduction in use and generation of hazardous substances may reduce the cost of conventional property insurance.

Second, reduced use of hazardous substances can reduce claims under health insurance. While few, if any, health coverages provide reductions in cost for reduction or elimination of hazardous substances, most provide for "experience based" reductions in claims. Consequently, if a reduction or elimination of hazardous substances does reduce medical claims, rates may be adjusted downward.

Finally, the absolute pollution exclusion **(See FACT SHEETS: *Standard Business Insurance* and *Environmental Insurance*)** does not limit all pollution based claims under comprehensive general liability insurance. Comprehensive general liability policies that include protection against liability for "personal injury" may be interpreted by courts to provide coverage for claims based on an invasion of privacy or the creation of a nuisance resulting from a release of pollutants, including hazardous substances. Consequently, a reduction in the use or generation of hazardous substances may reduce the probability of a personal injury claim and, as a result, justify reductions in the cost of some comprehensive general liability insurance policies.

How do insurers view pollution prevention?

Environmental insurance places strong emphasis on risk management, including pollution prevention. Materials describing environmental risk reduction in general terms are available at no cost from major insurers providing environmental insurance in both printed brochures and at Internet sites. Most major insurers providing environmental insurance also provide more specialized on-site assessment and engineering analysis through separate risk management units or divisions. (For a listing of major insurers providing environmental insurance, **see *Environmental Insurance Internet Sites, Publication #99-434*.)**

Such technical analysis and advice from an insurer prior to purchase of insurance is voluntary or, at most, a condition for sale or special rates. Once environmental insurance has been purchased, however, the insurer assumes a more direct interest in implementation of pollution prevention measures. Insurers may make implementation of basic pollution prevention measures a condition for continued coverage or may reduce rates of existing coverage if pollution prevention measures are implemented.

What role do pollution prevention standards play in environmental insurance?

Development of insurance coverage requires some estimate of the probability of an insured event. This calculation is facilitated by a norm or standard for factors contributing to such an event, e.g. the volume of hazardous substance use. A clear standard for pollution prevention, hazardous substance management, and clean-up makes the determination of liability and consequent damage awards more predictable. This, in turn, makes the risks associated with such standards, more "insurable".

Where a pollution prevention standard or set of best management practices has been established by a business trade association, environmental insurance may require that this standard or set of practices be met. In such situations, insurance coverage is dependent on pollution management and pollution prevention.

How do insurers evaluate the pollution prevention performance of an applicant for environmental insurance?

Most major environmental insurance providers require an environmental audit prior to issuing environmental coverage. An environmental audit looks at potential liabilities and potential risk reduction through pollution prevention or improved pollution management. The audits are always site specific; they can also include evaluation of the firm's capacity to identify liabilities and implement risk reduction measures. The audits vary in detail, ranging from a review of paperwork to on-site monitoring.

Increasingly, environmental audits for environmental coverage must meet technical insurance industry standards. These standards have been developed in response to initial environmental coverages written without sufficient awareness of potential risks related to pollution and consequent losses by major insurers.

What insurance benefits can a firm realize for implementation of P2 measurers?

As already noted, environmental coverage may be dependent on meeting certain standards for risk management. These standards may include both pollution prevention measures and measures related to management of remaining hazardous or polluting substances. In helping firms meet these standards, pollution prevention increases a firm's "insurability" for environmental coverage. According to one major insurer, failure to implement basic pollution prevention measures eliminates 90% of applicants for environmental insurance.

The number of factors to be considered in setting insurance rates makes it difficult to break out the precise significance of pollution prevention to rates charged for environmental insurance. All providers emphasize, however, that rates reflect risk and that reductions in risk are considered in the underwriting process.

Specific reductions in rates for environmental insurance may increasingly be linked to specific pollution prevention measures. Within the past few months, a major national insurance broker has negotiated an arrangement with five major providers of environmental insurance for reductions of up to 30% in rates where conformance to an industry wide standard for pollution prevention and environmental management can be demonstrated. The high profile of the broker, the participation of all major environmental insurance providers, and the involvement of a major industry association suggest the program could provide a major stimulus for increased coverage and increased pollution prevention. More importantly, if the program proves to be popular and profitable, it could be repeated in other industrial sectors.

Environmental coverage is evolving from comprehensive policies to more specialized policies. (**See FACT SHEET: *Environmental Insurance*.**) To take full advantage of the more specialized environmental policies, firms must, in the words of an industry writer, "impress the underwriter with their unique and creative solutions to environmental risk." The increased "insurability" that implementation of pollution prevention provides a firm may allow it to reduce costs by qualifying for new specialized coverages. Pollution prevention can also reduce the cost of conventional property insurance and of workers' compensation insurance.

How do firms in the market for environmental coverage view and pursue pollution prevention?

In light of the potential benefits of pollution prevention to insurability and, perhaps, to rates, some firms in the market for environmental coverage have been seeking to reduce risk through pollution prevention. In part, this is done through outside assistance, including technical assistance from potential insurers. Larger corporations often identify the opportunities for and benefits of pollution prevention through self-audits undertaken as part of environmental management systems.

Won't environmental insurance undercut pollution prevention by protecting against the potential damages pollution prevention seeks to reduce?

Some observers conclude that a "moral hazard" is, indeed, linked to environmental insurance. That is, once insured, firms do tend to reduce their commitment to risk reduction. To counter this, insurers attempt to monitor performance of insureds. Moreover, any increase in accident and claims usually results in increased rates or cancellation of coverage.

If you have questions or comments on this or other insurance fact sheets, please contact:

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